How China Grew Overnight

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By Charles Wolf Jr.

When the Asia-Pacific Economic Cooperation summit convenes in Seattle on Thursday, the briefing books of the assembled heads of government will contain data showing China's economy to be enormously larger than previously estimated, and nearly as large as that of Japan.

One of the professional secrets of people who work with supposedly "hard" data is that, in fact, the data are often "soft" and unreliable. The International Monetary Fund and the World Bank—two of the most respected sources of international economic data—recently provided a glimpse of this secret.

In May the IMF and the World Bank announced that China's gross domestic product was between four and five times greater in 1992 than they had previously estimated it to be. According to these re-estimates, China's economy is now the third largest in the world—after the U.S. and Japan. Together with plausible forecasts of China's economic growth in the next few decades—perhaps averaging 5% or 6% annually—the new IMF and World Bank estimates would, within the 1990s, make the economy of China larger than that of Japan. Were China to sustain such a high growth rate for several decades—which is unlikely—its GDP would overtake that of the U.S. during the third decade of the 21st century.

These remarkable recalculations and projections raise two questions: What accounts for the enormous discrepancy between the earlier and the current estimates? And what difference, if any, will this huge change in China's current economic size and its future prospects make for the world's economy and security?

The answer to the first question is straightforward. In their recent estimates, the IMF and World Bank converted Chinese yuan figures into 1992 dollars by using a "purchasing power parity" exchange rate, whereas in prior estimates they used a foreign exchange rate. The purchasing power rate is based on the cost of a specified basket of goods and services in yuan, compared with its cost in dollars. The foreign exchange rate depends on the official rate of exchange between the yuan and the dollar quoted by the IMF.

Foreign exchange rates are critically dependent on international capital movements that have little effect on PPP, while PPP is influenced by the relative prices of such nontradable services as health care, housing and construction, which have little effect on exchange rates.

Although there are some purposes for which it is appropriate to use foreign exchange rates in comparing national economies, for the specific purpose of comparing the relative size of different national economies the PPP rate is clearly preferable. In published work that RAND did for the National Commission on Integrated Long-Term Strategy in 1988, the PPP rate was used to make international comparisons between China's gross national product and the GNPs of more than a dozen other major national economies, including that of the U.S. The estimates recently announced by the IMF and the World Bank were remarkably similar to the earlier RAND results.

The IMF and World Bank are two of the most frequently cited sources of international economic data, but they are not alone in the magnitude of their misestimates. Overestimates by the Organization for Economic Cooperation and Development and by official U.S. government agencies of the national economies of East Germany and the then-Soviet Union prior to 1990 were nearly equivalent in scale to the previously cited underestimates of China's GDP by the IMF and the World Bank. Since even these supposedly reliable data sources are sometimes prone to large errors, caution is plainly warranted in using their data. When policy choices are influenced by data derived from these and similar sources, the chosen policies may be as unreliable as the shaky data on which they are based.

The answer to the second question, about what difference the re-estimates of the Chinese economy make in the international arena, has two parts: one economic, the other bearing on military and security matters.

A Chinese economy that is four to five times larger than it was previously believed to be, and continues to grow at a 5% to 6% annual rate, will play an equivalently expanded role in the world economy. In general, changes in a country's imports depend, among other factors, on the growth of its economy, as well as on its size. If China's economy becomes more open to foreign imports, and if one accepts the previously cited estimates that the size of the Chinese economy is currently about $2 trillion, China will become an increasingly important market for exports from the U.S. as well as from the Asia-Pacific region and the rest of the world.

China is still too small to be anything approaching the "locomotive" for the rest of the world's economies that the U.S. economy was in the 1970s and 1980s. But China, together with the rapidly growing Southeast Asian economies, amounts to about 40% of the size of the U.S. economy, and this may be large enough to be at least a "tractor" for the rest of the world. If such other factors as successful conclusion of the Uruguay round of GATT and adoption of growth-promoting tax policies by Asian countries proceed in favorable and reinforcing directions, the Asia-Pacific tractor can help significantly to pull the world's economies to higher ground.

The security dimension of China's changed and changing economic size is more unsettling, as well as more uncertain. China is currently the only major country whose military spending is increasing in real terms. About 8% of its GDP is allocated to defense to cover the operating costs of the four million men and women in its armed forces, as well as the costs of military modernization. These figures compare to GDP shares of 4% for the U.S., a little over 1% for Japan, and about 2% for the countries of Western Europe. Military allocations of this scale, from the large and growing economic base that China's GDP provides, are a source of increasing concern to China's neighbors.

Joseph Schumpeter, an economist whose interests and insights extended beyond the usual boundaries of economics, observed four decades ago that "militarism is rooted in the autocratic state, [whereas] the bourgeois [state] is unwarlike." The Asia-Pacific region, as well as the rest of the world, has much to gain from China's move from autocracy toward some semblance of bourgeois democracy—the latter, of course, "with a Chinese face."

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